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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Chairman Reed Hundt
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: **Designated entity rules for broadband PCS applicants**
(PP Docket No. 93-253)

Dear Chairman Hundt:

Impulse Telecommunications Corporation is an eight-year-old telecommunications consulting and engineering firm based in Dallas, Texas. For the last five years, nearly all its time has been devoted to projects related to PCS. While Impulse itself is a small business (as defined in the current PCS proceedings), its PCS clients have included many major telecommunications companies. As a result, Impulse has gained substantial knowledge and experience with PCS, and is precisely the kind of small business the Commission's designated entity rules were designed to encourage. The Company very much supports the Commission's efforts to ensure that small businesses, minorities and women are given an opportunity to participate in this exciting new technology.

It is Impulse's view, however, that the Commission's rules as currently configured will not permit adequate post-auction system build-out fund-raising by DEs. The PCS business will be highly capital intensive, and DEs will face competition in nearly every market from at least two experienced and well financed PCS competitors and two well-established cellular carriers. Given the nature of the competition, and the substantial expense required in successfully deploying a PCS network, the Commission should be certain that its rules do not unduly restrict DEs' access to capital.

As the following discussion demonstrates, Impulse believes that even though the requirement to hold a 25 percent equity stake at the outset is appropriate, the requirement to maintain 25 percent minimum equity *throughout the life of the venture* severely limits normal capital formation by DEs. The remainder of this letter explains the basis of the Company's concerns and suggests a minor revision to the Commission's rules which could remedy these constraints. As described in further detail below, we propose that after the auctions the FCC should *eliminate shareholders owning less than 5 percent when calculating the equity holdings of DEs*. This will allow access to a broad base of small shareholders.

Impulse believes that this minor rule change will alleviate the restraint on fund-raising and will ensure strong long-term competition from among the ranks of DEs while minimizing the possibility of sham applicants. It addition, it should not reduce the Commission's ability to detect insincere applications.

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1. The Capital Formation Problem

As an entrepreneur, let me present the capital problem as it appears from the point of view of a small business planning to bid in the BTA auction.

> The first capital formation problem is to raise funds for bidding. Assuming the BTA auctions go for a national average of around $35 per pop, with the top quality licenses going for three times that (some of our scenarios reflect these price levels). For an average BTA with one million population, at the average price of $35 per pop, the license cost will be $35 million. The small business DE buying the BTA gets a 10 percent bidding credit ($3.5 million) and gets the installment plan with 10 percent down payment. The down payment in this $35 million example comes to $3.15 million, leaving a $28.4 million debt. The pre-auction capital need is to raise all or most of $4 million, primarily to cover the down payment, but with some additional funds for legal fees, and a small reserve for getting started.
>
> As a small business with insight, energy, entrepreneurial spirit, the American Dream, *and little cash*, we need to sell our business plan to investors to raise that $4 million. Since small business needs investors to provide almost all the cash, we find that they normally expect a deal structured so that if all turns out well, we get a 15 to 20 percent interest, and they get 80 percent to 85 percent. After checking with numerous people knowledgeable in such transactions, we find that this expectation is in fact a "plain vanilla" deal. The financial markets generally expect to give up a carried interest to those who developed the concept and business plan, and who will manage the business. In fact, they usually insist on the founders' having that interest in order to provide proper incentives for success. In some cases, if the management team is particularly knowledgeable and experienced, the percentage can be slightly higher. That's the market price for start up capital.
>
> Fortunately, we have our entry to the Entrepreneur's block auction, our bidding credit, and our installment plan financing to contribute to the transaction. For a small business these can be valued at 10 percent initial equity interest. Therefore, with some difficulty, we can get initial financing and retain the 25 percent required by the FCC rules.
>
> The initial funds requirement is just the tip of the iceberg. Having raised that first $4 million, and spent most of it at the auction, we now face three large on-going demands for funds: debt payments (on the auction debt), capital spending (for construction of the expensive PCS network of cells), and operating expenses (we project five years of losses before turning a profit). We estimate six or seven years of negative cash flow. The amount needed each year varies, but runs at two or three times the initial $4 million. Just the first year interest payment alone is around $2.8 million (nearly equal to the down payment). The total needed over six years to successfully build the PCS business in our example BTA is $60 million (about twice the total amount bid).
>
> After successfully bidding and winning the license, we investigate both debt and equity prospects to provide this follow-on financing. Our equipment vendors offer to finance their equipment, and we expect to take on that additional debt. This helps, of course, but we still have to raise the cash to make the payments on that debt. We can't borrow any more money because we are already heavily leveraged (the auction debt and the equipment debt). So we have to turn to the equity markets, and sell part of the equity interest in the business. The equity markets are expected to work for us because in the long run we foresee a very profitable business. But we do face a substantial risk of selling stock at a lower price than planned.
>
> But selling equity necessarily requires us to accept dilution of our interest (note that our original investors get equally diluted). The dilution isn't too bad, because now we are a start up company

holding valuable assets -- the PCS licenses -- whereas before we were just selling a "potential". Our stock price is now dramatically higher, and we only take a 10 percent dilution to raise the first year's operating funds, dropping our ownership from 25 percent to 22.5 percent. Additional sales of stock over the next five or six years will dilute the original investors to about 50 percent, and so dilute our share from 25 percent to 12 percent. We need a total of about $60 million post-auction to make our $4 million seed grow into a self funding business.

This investment scenario is a reasonable transaction for all concerned, but unfortunately conflicts with the FCC rules for DE's in the PCS auctions. Those rules require that the DE equity ownership of 25 percent be retained for the ten year license period. We can handle the 25 percent requirement initially, but we can't retain that level of ownership.

If we start at 25 percent ownership, then no further dilution is allowed. At this point we are severely limited in how we raise the cash needed to make our payments on the installment loan and to fund the business.

If we could start at 50 percent ownership, then the 25 percent retained equity rules allow us to get diluted down to 25 percent as we sell stock for working capital. But then we have no way to raise the cash needed to get into the auction. Investors won't put up all the cash for only half of the return.

Neither of these alternatives works. Small business needs a modification of the rules and definitions to allow a successful challenge of giant competitors. The proposed change is presented below, but first let me present some additional information that supports the general scenario as outlined above.

Supporting Data

This illustration is typical, but the actual numbers would vary quite a bit depending on the nature of the BTA, the competition, the bid price in the auction, and so on. The following is based on a typical BTA with a population of almost one million. These forecasts are projections developed by Impulse's industry validated proprietary wireless industry econometric models and databases.

Bid Price Estimates

The market for cellular companies often shows transactions in the $200 to $300 per pop range for major properties. These values are the sum of the inherent license value, the current business value, and the present value of the estimates of future business cash flow. Business valuation is a complex field, and we use a variety of modeling techniques. For a PCS business in a typical BTA, one of our valuation models forecasts the following:

Valuation Analysis

		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
$Mil		66	71	78	86	95	105	116	129	144	159
$pop	37	76	83	91	100	110	121	133	147	163	179

We expect to be able to purchase this license in the auction for $37/pop, which is the price at which we forecast an acceptable level of return for our investors. By the end of year 1 we have increased that value to $76/pop by winning the license, and then putting staff and plans in place to startup the business. The value continues to grow as we roll out the capital equipment, start up operations, and attract customers. As this business achieves a market penetration similar to today's cellular businesses, it then also earns a similar market valuation.

PCS Start up Cash Flow

The three major categories of cash needs during the startup years for a PCS operating company are payment for the license, payment for the capital equipment, and cash for around five years of negative cash flow from operations, while operating expenses exceed revenues. Typical values for each of these are shown below.

Cash Flow Analysis

($Millions)	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
License Deposit	-2.8									
License Debt Service	-2.5	-2.5	-5.5	-5.2	-4.9	-4.6	-4.3	-4.0	-3.6	-3.3
Equip. Debt Service	-0.1	-0.5	-1.6	-2.2	-2.5	-2.8	-3.3	-3.4	-3.1	-3.3
Operating Income	-1.2	-3.7	-5.3	-4.6	-2.7	-0.1	2.7	5.6	8.4	11.0
	-6.7	-6.7	-12.5	-12.1	-10.1	-7.5	-4.8	-1.8	1.6	4.4

The capital equipment costs run around $10/pop for initial coverage, but grows with the number of subscribers and the calling traffic per subscriber. We assume that the equipment is financed by the equipment vendors, and our cash flow analysis shows the principal and interest payments on that debt.

Company operations run at a loss until year 6, and then start running at a profit as the number of subscribers grows. However, the debt service burden keeps the business from positive cash flow until the ninth year. The business inherently has large fixed costs and low marginal costs. Thus, it runs at a loss until reaching a critical mass of subscribers, but becomes highly profitable thereafter.

PCS Funding Dilution

This typical company raised $4 million pre-auction, and retained 25 percent ownership for the founders. Then, in order to meet the cash requirements through year 8, the company needed to accept dilution of ownership in order to sell stock and remained in control throughout the period. However, as the company valuation grows, the stock sells at increasingly higher prices, and the dilution is not excessive.

As shown above, the company needs $6.7 million in the first full 12 months of operations. Given the scenario outlined, the company raised $4 million of initial seed equity and used $2.8 million of that for the auction down payment. The company thus needs a stock offering to raise another $2.7 million just to survive the first year.

The projected dilution is shown below.

Dilution Analysis

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Founders' shares	25%	22%	18%	15%	14%	12%	12%	12%	12%	12%
Seed investors shares	75%	67%	55%	46%	41%	37%	35%	35%	35%	35%
Other investors	0	11%	27%	39%	46%	50%	53%	54%	54%	54%

This example shows for this BTA and business scenario, the founder's initial 25 percent equity ownership is diluted down to 12 percent, even though the founders did not sell any of their stock.

2. The Goals of the DE Rules

The Commission has included special DE rules in its PCS plan in order to provide opportunities for DEs in a highly capital intensive and uncertain new marketplace. Impulse agrees inclusion of these groups in PCS will help to bring a new source of energy, entrepreneurism and sustainable competition to the telecommunications market.

At the same time, the Commission has sought to prevent abuses of its DE rules. The benefits of the policy should be directed toward the intended recipients, not misappropriated for the good of otherwise ineligible entities. Such abuses have occurred in other services and the Commission rightly hopes to avoid them here.

The principal means chosen to protect the integrity of the DE rules are: (1) a restriction of transfers of DE held properties and a recapture of DE benefits where such transfers occur; (2) a requirement that the DE-eligible control group maintain control of the licensee at all times; (3) a limit of 25 percent on the equity held by any non-eligible investor; and (4) a minimum equity requirement of 25 percent for the DE control group. While Impulse supports all four of these requirements in concept, our analysis demonstrates the choice of 25 percent as a minimum equity requirement *throughout the life of the venture* creates serious financing hurdles for DEs.

3. The Solution

Impulse believes its recommendation will remove barriers to DE capital formation, will strengthen the Commissions policy goals, and will reduce the potential for rule abuse. Impulse is proposing no changes in limitations on license transfers, non-eligible investor voting and equity interests, or in DE control. Nor does Impulse recommend changing the 25 percent minimum equity requirement.

Impulse proposes that the Commission change the method of calculating a DE's minimum equity interest. Rather than mandate that DEs hold 25 percent of the entire enterprise, the rules should require that DEs own an equity stake at least equal to 25 percent of the total equity at the outset, and thereafter (post auction) own an equity stake of 25 percent of the total equity <u>held by stockholders with more than 5 percent.</u> This plan would permit DEs to raise capital from numerous small investors (such as the public equity markets) even if they then fall below 25 percent equity, without subjecting them to the threat of pressure from other large investors who might seek to exert undue influence.

We could rely on the SEC rule requiring that anyone acquiring greater than 5 percent interest in the company must file a form 13d or 13g to notify the company and the SEC of that event. (Note that this notification mechanism is relied upon by the IRS for similar purposes.)

In this way, the Commission can allow DEs to fall below 25 percent of the total equity without increasing the risk that the DE will lose control of the enterprise in the process. This minor modification in the minimum equity requirement, coupled with retention of all other DE requirements, will preserve the Commission's policy goals while greatly enhancing a DE's ability to raise operating capital after the auction.

Finally, a brief comment is required on a recent proposal to limit further the number of PCS licenses any individual designated entity could purchase. Specifically, the Small Business PCS Association suggested, in its petition for reconsideration, that the 10 percent limit on designated entity PCS licenses be modified to limit DEs to 10 percent <u>population coverage</u>, rather than 10 percent of licenses. Impulse believes this is a poorly conceived proposal which, if adopted, could add additional burdens to DEs seeking financing.

DEs entering the PCS marketplace will face competition from two well-financed PCS providers operating on a broad MTA basis. In addition, in most metropolitan areas two financially powerful cellular companies will be in operation on a regional basis. Against this backdrop, DEs must formulate bidding strategies and procure financing to create a competitively viable approach to the purchase of PCS licenses. The formidable competitive forces which will already be in place, plus the need to arrange large amounts of financing from investors who must remain passive beyond their customary role, present DEs with a sufficient challenge in their attempt to establish a successful PCS business. The additional constraint of an artificial limitation on the number of potential customers a DE can serve, especially set as low as 10 percent, will unduly complicate already complex bidding strategies. And by calling into question a DE's ability to regionalize a PCS operation (along the lines of the successful cellular operations), many potential investors may lose interest in the PCS opportunity.

In short, the previous portions of this letter have outlined many of the difficulties faced by DEs in raising capital under the existing set of rules. As discussed above, if modifications to this scheme are to be enacted, they should be aimed at giving DEs assistance through greater flexibility, not burdening them further with additional constraints. The current rule limiting DEs to 10 percent of PCS licenses should be left intact.

In closing, Impulse urges the Commission to adopt the rule revision proposed herein promptly. Broadband PCS auctions for the Entrepreneurial blocks are expected this spring, and DEs already are working diligently to arrange financing. The sooner the Commission can remove barriers to DE capital formation and bring certainty to the financial markets, the sooner Impulse and many other DEs can finalize their fund-raising efforts and ensure the success of the Commission's policies.

Thank you very much for your consideration.

Sincerely,

Ed Jungerman

Edward E. Jungerman
President and CEO

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